D. IRC 4942(g) - QUALIFYING DISTRIBUTIONS

1. Introduction

More than two decades ago, the Treasury Department issued a Report on Private Foundations, which, to a great extent, served as the basis for the changes enacted by Congress in the Tax Reform Act of 1969. Under the rubric of "Delay in Benefit to Charity", Treasury described a situation in which an immediate deduction was allowed for contributions to nonoperating foundations that invest in unproductive assets or merely accumulate income. The justification for an immediate deduction was not readily apparent where such amounts were added to the foundation's corpus, or made part of an investment generating less than a reasonable amount of current income. With a view toward correcting the problem of the delay in the benefit to charity, Congress enacted IRC 4942, which requires private foundations to distribute a current return to charity for taxable years beginning after December 31, 1969. One of the crucial concepts contained in IRC 4942 is that of a "qualifying distribution." In order to meet the minimum distribution requirements of IRC 4942, a private foundation's distributions must be "qualifying distributions" within the meaning of IRC 4942(g).

Although IRC 4942 contains a number of important terms, such as "minimum investment return" and "private operating foundation," the focus of this topic will be limited to "qualifying distributions." The purpose of this topic is to present an in-depth discussion of qualifying distributions - what they are, how they are treated, and how they fit within the statutory scheme created by Congress to prevent delay in the benefit to charity.

2. Background

A. Legislative History

Among the many issues addressed by Congress in the Tax Reform Act of 1969 was the problem of private foundations that fail to make reasonable, minimum distributions for charitable purposes. Before 1969, private foundations were relatively free to accumulate funds with little fear of being forced to distribute amounts to charity. The relevant statutory provision at that time, IRC 504(a)(1), provided that a private foundation would lose its tax-exempt status, if its aggregate accumulated income were unreasonable in amount or duration in order to carry out its exempt purposes under IRC 501(c)(3). The above mentioned Report on Private

Foundations and another Treasury study entitled Tax Reform Studies and Proposals echoed the belief that existing law, with its emphasis on the "reasonableness" of accumulations, was inadequate, as well as difficult and expensive to administer. The consequence of unreasonable accumulations - revocation of exemption - was viewed as being quite drastic, and hence infrequently invoked. The fatal flaw attendant to IRC 504(a)(1) was the necessarily subjective nature of determinations made in connection with the reasonableness or unreasonableness of a private foundation's accumulations. The solution selected by Congress to ensure that charity would receive adequate distributions from private foundations is found in IRC 4942, which imposes an excise tax on the undistributed income of private foundations. Amounts distributed must be "qualifying distributions" within the meaning of IRC 4942(g).

House Report 91-413, (Part I), 1st Session, on the Tax Reform Act of 1969; 1969-3 C.B. 216, 3. Distributions of Income, contains the following discussion of qualifying distributions:

> "For the purpose of this mandatory payout requirement, qualifying distributions include distributions to "public charities" and to private operating foundations, direct expenditures for charitable purposes, and expenditures for assets to be used for charitable purposes. A contribution to another private foundation is not forbidden, but (except in the case of a contribution to a private operating foundation) it may be made only in addition to qualified distributions that meet the minimum payout requirement. Essentially the same rules apply as to foreign expenditures; that is, a payment does not qualify if made to a foreign organization which would be a private foundation under our law if it were a domestic organization. This rule is intended to prevent several foundations from distributing their income to each other without the income being used for charitable purposes. These distribution requirements do not apply to a private operating foundation and, as indicated above, a private operating foundation is a qualified recipient of such distributions."

B. Code Provisions

IRC 4942(a) imposes a 15 percent tax on a private foundation's undistributed income, which is described in IRC 4942(c) as the amount by which the "distributable amount" exceeds "qualifying distributions." IRC 4942(g)(1)(A) defines the term "qualifying distribution" as any amount (including that portion of reasonable and necessary administrative expenses) paid to accomplish one or more purposes described in IRC 170(c)(2)(B). Under IRC 4942(g)(1)(B) the term "qualifying distribution" includes any amount paid to acquire an asset used (or held for use) directly in carrying out one or more purposes described in IRC 170(c)(2)(B). A qualifying distribution generally does not include: (i) any contribution to an organization controlled by the foundation or a disqualified person with respect to the foundation, or (ii) any contribution to a nonoperating foundation.

IRC 4942(g)(2)(A) provides that an amount set aside for a specific project, which comes within one of the purposes described in IRC 170(c)(2)(B) may be treated as a qualifying distribution, if it meets the various requirements for a set-aside contained in IRC 4942(g)(2)(B). In accordance with these requirements the foundation must establish that the amount set aside will be paid for a specific project within five years, and the project is one that can be better accomplished by the set-aside than by an immediate payment of funds. Alternatively, an amount set aside may be treated as a qualifying distribution, if the foundation distributes certain minimum amounts of funds during specific years.

An exception to the general rule that a private foundation cannot make qualifying distributions to controlled organizations or nonoperating foundations is contained in IRC 4942(g)(3). This provision, which is called the "twelve-month pass-through" rule, permits an amount contributed to a controlled organization or a nonoperating foundation to be treated as a qualifying distribution, if the donee organization makes a distribution equal to the amount of the contribution not later than the close of the first taxable year after the taxable year in which it received the contribution. Also, the donee organization's distribution of the contribution must be a qualifying distribution out of corpus, and the private foundation making the contribution must obtain adequate records or other sufficient evidence showing that the donee organization made a qualifying distribution.

IRC 4942(g)(4) sets forth limitations on administrative expenses allocable to making contributions, gifts and grants. IRC 4942(h)(1) provides that qualifying distributions are treated as being made first out of undistributed income of the immediately preceding taxable year; second, out of undistributed income for the taxable year; and, then out of corpus. IRC 4942(h)(2) discusses correction of deficient distributions for prior taxable years, and IRC 4942(i) provides for the carryover of excessive distributions.

3. <u>General Principles</u>

A. Types of Qualifying Distributions

Reg. 53.4942(a)-3(a)(1) states that the amount of a qualifying distribution of property is the fair market value of the property as of the date the qualifying distribution is made. Also, the amount of an organization's qualifying distributions is determined solely on the cash receipts and disbursements method. The definition of "qualifying distribution" is somewhat expanded in Reg. 53.4942(a)-3(a)(2), which refers to program-related investments defined in IRC 4944, and states that IRC 170(c)(1) purposes (in addition to IRC 170(c)(2)(B) purposes) can be appropriately accomplished by a qualifying distribution.

In general, qualifying distributions include amounts paid to accomplish one or more purposes described in IRC 170(c)(2)(B) or 170(c)(1), amounts paid to acquire an asset used (or held for use) directly in carrying out one or more purposes described in IRC 170(c)(2)(B) or 170(c)(1), or any amount set aside which meets the requirements for a set-aside under IRC 4942(g)(2).

Chapter (14)60 of IRM 7752 gives the following examples of expenditures for direct charitable activities: amounts paid or set aside to acquire or maintain the operating assets of a museum, library, or historic site, or to operate such facility; to provide goods, shelter, or clothing to indigents or disaster victims if the foundation maintains some significant involvement in the activity rather than merely making grants to recipients; to conduct educational conferences and seminars; to operate a home for the aged or disabled; to conduct scientific, historic, public policy, or other research with significance beyond the foundation's grant program, and which does not constitute a proscribed attempt to influence legislation; to publish and disseminate the results of such research, reports of educational conferences, or similar educational material; to support the service of foundation staff on boards or advisory committees of other charitable organizations, or on public commissions or task forces; to provide technical advice or assistance to a governmental body, a governmental committee or subdivision of either in response to a written request by the governmental body, committee or subdivision; and, to conduct performances in the performing arts. Technical assistance must have significance beyond the purposes of the grants made to grantees, and must not consist merely of monitoring or advising the grantees in their use of grant funds. Technical assistance involves the furnishing of expert advice and related assistance regarding, for example, compliance with governmental regulations, reducing operating costs or increasing program accomplishments, fund-raising methods, and maintaining complete and accurate financial records.

Direct expenses, which can be specifically identified with a particular activity, include compensation and travel expenses of employees and officers, the cost of materials and supplies, and fees paid to outside firms and individuals. Indirect (overhead) expenses, which are not specifically identifiable with a particular activity, include expenses of occupancy; supervisory and clerical compensation; repair, rental, and maintenance of equipment, and expenses of other departments, such as accounting, personnel, and payroll that serve the department or function that incurs the direct expenses of conducting an exempt activity.

Other qualifying distributions include expenses attributable to soliciting grants or contributions to the foundation; preparing Form 990-PF, publishing the required newspaper notice to inform the public that the return is available for inspection upon request; making the return available for public inspection or providing copies, and publishing the annual report available to the public.

The following examples of qualifying distributions are contained in Reg. 53.4942(a)-3(a)(8):

> **Example (1)**. M, a private foundation which uses the calendar year as the taxable year, makes the following payments in 1970: (i) a payment of $44,000 to five employees for conducting a foundation program of educational grants for research and study; (ii) $20,000 for various items of overhead, 10 percent of which is attributable to the activities of the employees mentioned in payment (i) of this example and the other 90 percent of which is attributable to administrative expenses which were not paid to accomplish any section 170(c)(1) or (2)(B) purpose; and (iii) a $100,000 general purpose grant paid to an educational institution described in section 170(b)(1)(A)(ii) which is not controlled by M or any disqualified persons with respect to M. Payments (i) and (ii) of this example are qualifying distributions to the extent of $46,000 ($44,000 of salaries and 10 percent of the overhead, both of which are reasonable administrative expenses paid to accomplish section 170(c)(1) or (2)(B) purposes). Payment (iii) of this example is also a qualifying distribution, since it is a contribution for section 170(c)(2)(B) purposes to an organization which is not described in subparagraph (2)(i)(a) or (b) of this paragraph. The other 90 percent of payment (ii) of this example may constitute items of deduction under paragraph (d)(1)(ii) of Section 53.4942(a)-2 if such items otherwise qualify under such paragraph.

Example (2). On February 21, 1972, N, a private foundation which uses the calendar year as the taxable year, pays $500,000 for real property on which it plans to build hospital facilities to be used for medical care and education. The real property produces no income and the hospital facilities will not be constructed until 1974, according to the set-aside plan submitted to and approved by the Commissioner pursuant to paragraph (b) of this section. The purchase of the land is a qualifying distribution under subparagraph (2)(ii) of this paragraph. If, however, the property were used to produce rental income for more than a reasonable period of time before construction of the hospital is begun, then as of the time such rental use becomes unreasonable (i) such purchase would no longer be deemed to constitute a qualifying distribution under subparagraph (2)(ii) of this paragraph and (ii) the amount of the qualifying distribution would be included in N's gross income. See paragraphs (c)(3)(i) and (d)(2)(iii)(b) of Section 53.4942(a)-2.

Example (3). In 1971, X, a private foundation engaged in holding paintings and exhibiting them to the public, purchases an additional building to be used to exhibit the paintings. Such expenditure is a qualifying distribution under subparagraph (2)(ii) of this paragraph. In 1975, X sells the building. Under paragraph (d)(2)(iii)(b) of Section 53.4942(a)-2, all of the proceeds of the sale (less direct costs of the sale) are included in X's gross income for 1975.

Example (4). In January, 1969, M, a private foundation which uses the calendar year as the taxable year, borrows $10 million to give to N, a private college, for the construction of a science center. M borrowed the money from X, a commercial bank. M is to repay X at the rate of $1.1 million per year ($1 million principal plus $0.1 million interest) for 10 years beginning in January, 1973. M distributed $5 million of the borrowed funds to N in February 1969, and the other $5 million in March 1970. M files a statement with the form it is required to file under section 6033 for 1973 which contains the information required by subparagraph (4)(ii)(b) of this paragraph. Pursuant to M's election, each repayment of loan principal constitutes a qualifying distribution in the year of repayment. Accordingly, the distribution of $5 million to N in March 1970 will not be treated as a qualifying distribution. Each payment of interest ($0.1 million annually) with respect to M's loan from X is treated as a deduction under paragraph (d)(1)(ii) of Section 53.4942(a)-2 in the taxable year in which it is made.

Example (5). Private foundation Y engages in providing care for the aged. Y makes a distribution of cash to H, a hospital described

> in section 170(b)(1)(A)(iii) which is not controlled by Y or any disqualified person with respect to Y. The distribution is made subject to the conditions that H will invest the money as a separate fund which will bear a name commemorating the creator of Y and will use the income from such fund only for H's exempt hospital purposes which relate to care for the aged. Under these circumstances, the distribution from Y to H is a qualifying distribution pursuant to subparagraph (2)(i) of this paragraph.

Other issues involving qualifying distributions generally have been addressed in a number of revenue rulings and in one court case.

In Rev. Rul. 80-97, 1980-1 C.B. 257, the Service considered whether an unrestricted contribution to a cemetery company exempt under IRC 501(a) as an organization described in IRC 501(c)(13) is a qualifying distribution. The revenue ruling notes that although a cemetery company exempt under IRC 501(c)(13) is eligible to receive deductible contributions under IRC 170(c)(5), it is not organized and operated exclusively for IRC 170(c)(2)(B) purposes. On this basis, amounts paid to the cemetery company are not qualifying distributions.

Rev. Rul. 79-375, 1979-2 C.B. 389, describes a private foundation that purchases a building for use directly in carrying out its exempt purposes. The foundation claimed a qualifying distribution for the purchase price of the building. Subsequently, the foundation donated the building to an exempt public charity to be used in accomplishing IRC 170(c)(2)(B) purposes. The revenue ruling holds that since the foundation had previously taken a qualifying distribution for the purchase price of the building, it cannot be allowed a second qualifying distribution for an amount that represents the same expenditure. However, it will be allowed a qualifying distribution to the extent the fair market value of the building on the date of the contribution exceeds the amount of the first qualifying distribution.

Low interest loans to the blind are considered in Rev. Rul. 78-90, 1978-1 C.B. 380. These loans were given to blind persons, who desire to establish themselves in business, but are unable to obtain the necessary funds through commercial sources. The revenue ruling states that the loan program accomplishes a charitable purpose by increasing the economic opportunities of the blind and alleviating their distress. The revenue ruling concludes that the loans are program-related investments under IRC 4944(c), and also qualifying distributions under IRC 4942(g).

The treatment of legal fees is addressed in Rev. Rul. 75-495, 1975-2 C.B. 449. The revenue ruling describes an organization formed to pay a certain percentage of its net income to a literary society, so long as the literary society, as an integral part of its operations, promotes the writings of William Shakespeare. If the literary society fails to promote Shakespeare's works, the organization's distributions are to be made to a college. The college alleged that the literary society was not actively promoting Shakespeare and brought suit in order to obtain a court order designating the proper beneficiary. As a result of this litigation, the organization paid legal fees that were reasonable in amount. The revenue ruling concludes that the legal fees were paid to accomplish an exempt purpose and, therefore, such payment constitutes a qualifying distribution.

How to treat depreciation was considered in Rev. Rul. 74-560, 1974-2 C.B. 389. There, an organization constructed a building for use in direct furtherance of IRC 170(c)(2)(B) purposes. The organization sought to have an amount equal to straight-line depreciation for a particular year treated as a qualifying distribution. The revenue ruling holds that an amount recorded for depreciation is not a qualifying distribution.

In <u>H. Fort Flowers Foundation, Inc. v. Commissioner</u>, 72 T.C. 399 (1979), the court considered whether income used to restore to corpus an amount contributed to a university is a qualifying distribution. In 1965, the organization contributed $200,000 in cash to Vanderbilt University to be used for construction of a library. The organization treated the $200,000 contribution as a distribution of accumulated income, current income, and future income. From 1965 to 1973, most of the organization's income was applied to restoration of principal. The court concluded that amounts used to restore the organization's corpus were not qualifying distributions.

B. <u>Set-Asides</u>

An amount "set aside" in one year for a specific project, but actually paid out in future years, may be treated as a qualifying distribution if the requirements of IRC 4942(g)(2) are satisfied. These requirements may be satisfied either by meeting a "suitability test" or a "cash distribution test."

In accordance with the suitability test, a private foundation must establish that the specific project for which an amount is set aside is a project that can be better accomplished by the set-aside than by the immediate payment of funds, and that the amount set aside will be paid for the specific project within 60 months after it is set aside. Specific projects that can be better accomplished by the use of a set-aside include, but are not limited to, projects in which relatively long-term grants or expenditures must be made in order to assure the continuity of particular charitable projects or program-related investments (defined in IRC 4944(c)), or where grants are made as part of a matching-grant program. Such projects include a building to house an exempt activity of the private foundation, such as a museum, or a plan to purchase a group of paintings offered for sale only as a unit that consequently requires a large expenditure. A request for approval of a set-aside under the suitability test must be submitted before the end of the taxable year in which the amount is set aside.

The cash distribution test is described in Reg. 53.4942(a)-3(b)(3), and requires that certain minimum amounts of funds be distributed over a specified period of time. In contrast to the suitability test, the cash distribution test does not require advance approval by the Service. Also, the foundation need not establish that the project for which the amount is set aside can be better accomplished by the set-aside than by the immediate payment of funds.

Generally, a set-aside, that is approved under the suitability test, or that satisfies the cash distribution test, must be evidenced by the entry of a dollar amount on the books and records of a private foundation as a pledge or obligation to be paid at a future date or dates. If the suitability test or cash distribution test is satisfied, the 60 month period for paying the amount set aside may be extended, for good cause shown. A contingent set-aside is possible where a foundation becomes involved in litigation, and cannot distribute assets or income because of a court order.

For a more thorough discussion of set-asides, see the 1984 Exempt Organizations Annual Technical Review Institutes (CPE) Text, p. 282.

C. Borrowed Funds

The treatment of borrowed funds is described in Reg. 53.4942(a)-3(a)(4). The general rule is that if a private foundation borrows money in a particular taxable year to make expenditures for a specific charitable purpose, a qualifying distribution out of the borrowed funds will be allowed only at the time the borrowed funds are actually distributed for exempt purposes. In other words, a repayment of funds borrowed to make charitable expenditures is ordinarily not a qualifying distribution; only the distribution of the borrowed funds for charitable purposes is a qualifying distribution.

An exception to the general rule covers funds borrowed in a taxable year beginning before January 1, 1970, or borrowed pursuant to a written commitment binding as of the last day of such taxable year. At the election of the foundation, repayments of the loan principal of such borrowed funds made after December 31, 1969, may be treated as qualifying distributions at the time the loan principal is repaid. The election is made by attaching a statement to Form 990-PF for the first taxable year beginning after December 31, 1969, in which a repayment of loan principal is made. The statement is to be made part of the form, and is to be attached to the form for succeeding taxable years in which the repayment of loan principal is made. The statement must contain the name and address of the lender, the specific use made of the borrowed funds, and the private foundation's election to treat repayments of loan principal as qualifying distributions. Interest paid with respect to borrowed funds is treated as a deduction in the taxable year in which it is made.

In H. Fort Flowers Foundation, Inc. v. Commissioner, supra, the court held that the exception for borrowed funds was not available where the foundation distributed amounts from its corpus to a university, and subsequently "repaid the loan" over a period of eight years. The court found that under state law and for tax purposes there was no loan, since the foundation was merely borrowing from itself.

D. Changes in the Use of an Asset

Under Reg. 53.4942(a)-3(a)(5) if an asset not used (or held for use) directly in carrying out exempt purposes is subsequently converted to such a use, the foundation may treat such conversion as a qualifying distribution. The amount of the qualifying distribution is the fair market value of the converted asset as of the date of its conversion. Fair market value is determined by making a valuation of the asset as of the conversion date in accordance with the valuation rules discussed in Reg. 53.4942(a)-2(c)(4). Rev. Rul. 78-102, 1978-1 C.B. 179, holds that the correct conversion date of real property converted from nonexempt to exempt uses is the date the foundation adopts and immediately proceeds to implement a plan for the exempt use, even though the actual conversion is not completed until the following year.

E. Foreign Organizations

Distributions for IRC 170(c)(2)(B) purposes to a foreign organization, which has not received a ruling or determination letter that it is an organization described in IRC 509(a)(1), (2), or (3) or 4942(j)(3), will be treated as a distribution to an organization so described, if the distributing foundation has made a "good faith determination" that the donee organization is described in one of the appropriate Code provisions. Under Reg. 53.4942(a)-3(a)(6), a "good faith determination" will be considered made where it is based on an affidavit of the donee organization or an opinion of counsel representing either the distributing foundation or the donee organization. The affidavit or opinion must contain sufficient facts concerning the operations and support of the donee organization for the Service to determine that the donee would be likely to qualify as an organization described in IRC 509(a)(1), (2), or (3), or 4942(j)(3). A "foreign organization" means any organization not described in IRC 170(c)(2)(A).

4. Miscellaneous Issues

A. Grant Administrative Expenses

Prior to the Deficit Reduction Act of 1984, a private foundation was allowed to include administrative expenses to an unlimited extent as part of its qualifying distributions. For taxable years beginning after December 31, 1984, (but not for taxable years beginning after December 31, 1990) there is a limitation on the amount of grant administrative expenses that can be treated as qualifying distributions. The limitation is applicable to the qualifying distribution requirements of both operating and nonoperating foundations. In accordance with the limitation, the amount of grant administrative expenses paid during any taxable year may not exceed the excess (if any) of 0.65% of the sum of the net assets of the private foundation for such taxable year and the immediately preceding two taxable years, over the aggregate amount of grant administrative expenses paid and taken into account as qualifying distributions in the two preceding taxable years.

The primary effect of this formula is to ensure that, of the 5% of the net assets that a private nonoperating foundation must distribute under IRC 4942(d) and (e), at least 4.35% of that amount, less taxes imposed by IRC 511 and IRC 4940, will be distributed as charitable gifts or grants. The formula takes into account a three year averaging period that would allow a foundation to have grant administrative expenses in excess of 0.65% to the extent it has not used its full allowance in the two earlier years. Conversely, excessive prior year administrative expenses would decrease permissible current year administrative expenses. For years in the averaging period beginning before January 1, 1985, a transitional rule limits the grant administrative expenses that need to be taken into account to 0.65%.

The term "grant administrative expenses" means any administrative expenses directly or indirectly allocable to the making of contributions, gifts, or grants that are qualifying distributions. Certain other administrative expenses that are not grant administrative expenses may be included as qualifying distributions without limitation if they are incurred directly for the active conduct by the foundation of exempt activities of the foundation, or in making program-related investments described in IRC 4944(c). Thus, the administrative expenses of a private operating foundation that are used directly in the active performance of its exempt activities are considered qualifying distributions not subject to the 0.65% limitation.

As noted above, the limitation on grant administrative expenses is applicable for taxable years beginning after December 31, 1984, and will no longer be effective in taxable years beginning after December 31, 1990. During this interim period, in accordance with Congressional directions, the Service has undertaken a Private Foundation Grant Administrative Study. This Study is intended to cover administrative expenses incurred by private foundations, the amount of qualifying distributions that actually reach charitable beneficiaries, and the effect of the new limitation. Upon completion of the Study, findings will be presented to Congress.

B. The Twelve-Month Pass-Through Rule

A qualifying distribution generally does not include: (i) any contribution to an organization controlled by the foundation or a disqualified person with respect to the foundation, or (ii) any contribution to a non-operating foundation. Reg. 53.4942(a)-3(a)(3) clarifies when an organization is "controlled" for purposes of determining whether the organization can be a recipient of a qualifying distribution. Control is present if a foundation, or one or more disqualified persons with respect to the foundation may, by aggregating their votes or positions of authority, require the donee organization to make an expenditure, or prevent the making of an expenditure, regardless of the method by which control is exercised or exercisable. The regulation states that it is the donee, not the distribution, which must be controlled by the distributing private foundation. Furnishing support to an organization and imposing budgetary procedures upon the organization does not in itself result in the organization's being subjected to the distributing foundation's control. The controlled organization need not be a private foundation; it may be any type of exempt or nonexempt organization, including a school, hospital, operating foundation, or social welfare organization. An organization that is controlled by a private foundation, like a private non-operating foundation, is generally not a potential recipient of qualifying distributions.

The reason for this prohibition is that private nonoperating foundations carry out their charitable purposes in an indirect manner by making grants to individuals or to other organizations directly engaged in exempt activities. If one private foundation distributes funds to another private foundation, the totality of funds available for active and direct charitable uses will not ordinarily be increased. Similarly, if a private foundation makes a distribution to a controlled organization, the common control would tend to delay use of the funds in furthering active charitable purposes. To ensure that distributions of private foundation income flow promptly into the stream of funds sustaining direct charitable activity, IRC 4942 imposes strict requirements on distributions to another private nonoperating foundation or to a controlled organization. Amounts distributed to another nonoperating foundation or to a controlled organization may be treated as qualifying distributions only if the donee organization places an equivalent amount in the active charitable stream within twelve months after the taxable year in which the contribution is received.

Under Reg. 53.4942(a)-3(c)(1) a contribution to a private nonoperating foundation or a controlled organization is treated as a qualifying distribution if:

(i) The donee organization in turn, makes a distribution equal to the full amount of such contribution not later than the close of the first taxable year after the taxable year in which it received the contribution;

(ii) The donee organization's distribution of the contribution is a qualifying distribution which is treated under IRC 4942(h) as a distribution out of the donee's corpus (or would be so treated if the donee were a private foundation which is not an operating foundation); and

(iii) The private foundation making the contribution obtains adequate records or other sufficient evidence from the donee organization which:

(a) Shows that the donee organization has made a qualifying distribution of the contribution;

(b) Describes the names and addresses of the recipients thereof; and

(c) Shows that as to the donee the distribution is treated as made out of corpus under IRC 4942(h) or would be so treated if the donee were a private foundation which is not an operating foundation.

The regulations contain a number of specific rules with respect to the applicability of the "Twelve-Month Pass-Through" exception. Items covered include administrative expenses, distribution requirements, the treatment of a "failed pass-through," valuation of contributions, characterization of qualifying distributions, and prior distributions out of corpus. Reg. 53.4942(a)-3(c)(4) provides that where a private foundation makes a distribution to a donee organization which the donee uses to make payments to another organization (the secondary donee), the latter distribution is not regarded as a contribution by the private foundation to the secondary donee, if the contribution was not earmarked for the secondary donee, and the foundation does not retain power to cause selection of the secondary donee.

The following examples of the "Twelve-Month Pass-Through Rule" are contained in Reg. 53.4942(a)-3(c)(3):

> **Example (1)**. In 1972 M, a private foundation, makes a contribution out of 1971 income to X, another private foundation which is not an operating foundation. The contribution is the only one received by X in 1972. In 1973, X makes a qualifying distribution to an art museum maintained by an operating foundation in an amount equal to the amount of the contribution received from M. X also distributes all of its undistributed income for 1972 and 1973 for other purposes described in section 170(c)(2)(B). Under the provisions of paragraph (d) of this section, such distribution to the museum is treated as a distribution out of corpus. Thus, M's contribution to X is a qualifying distribution out of M's 1971 income provided M obtains adequate records or other sufficient evidence from X showing the nature and amount of the distribution made by X, the identity of the recipient, and the fact that the distribution is treated as made out of corpus. If X's qualifying distributions during 1973 had been equal only to M's contribution to X and X's undistributed income for 1972, X could have made an election under paragraph (d)(2) of this section to treat the amount distributed in excess of its 1972 undistributed income as a distribution out of corpus and in that manner satisfied the requirements of this paragraph.
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> **Example (2)**. Assume the facts stated in example (1), except that X is a private college described in section 170(b)(1)(A)(ii) which is

controlled by disqualified persons with respect to M and that the records which X furnishes to M show that the distribution would have been treated as made out of corpus if X were a private non-operating foundation. Under these circumstances, the result is the same as in example (1).

Example (3). Assume the facts stated in example (1), except that X makes a distribution to the museum equal only to one-half of the contribution from M, that the remainder of such contribution is added to X's funds and used to pay charitable administrative expenses, and that the records obtained by M from X are not sufficient to show the amounts distributed or the identities of the recipients of the distributions. The contribution by M to X will be a qualifying distribution only to the extent that M can obtain (i) other sufficient evidence (such as statements from officers or employees of X or from the museum) showing the facts required by subparagraph (1)(ii)(a), (b), and (c) of this paragraph and (ii) a statement from X setting forth that the remainder of the contribution was used for charitable administrative expenses which constituted qualifying distributions described in paragraph (a)(2)(i) of this section.

Example (4). X and Y are private non-operating foundations. A is an exempt organization which is not described in section 501(c)(3) but which supervises and conducts a program described in section 170(c)(2)(B). Y, but not X, controls A within the meaning of paragraph (a)(3) of this section. In 1972, X and Y each makes a grant to A of $100, specifically designated for use in the operation of A's section 170(c)(2)(B) program. X has made a qualifying distribution to A because the distribution is one described in paragraph (a)(2)(i) of this section. However, because A is controlled by Y, Y's grant of $100 to A does not constitute a qualifying distribution within the meaning of such paragraph (a)(2)(i). Furthermore, because A is not an exempt organization described in section 501(c)(3), Y's grant to A does not constitute a qualifying distribution by operation of the provisions of this paragraph.

Example (5). N, a private non-operating foundation, had distributable amounts of $100 in 1970 and $125 in 1971. In 1970 N received total contributions of $540: $150 from Y, a public charity; $70 from Z, a private foundation; $140 from Q, a private foundation, subject to the requirement that N earmark the amount and distribute it before distributing Z's contribution; and, $180 from R, also a private foundation. However, R specifically instructed N that such contribution did not have to be redistributed because R already had made enough qualifying distributions to avoid all section 4942 taxes. N is not controlled by Y, Z, Q, or R, and N made no qualifying distributions in 1970. By the close of 1971, N had made qualifying distributions of $420, earmarking $140 as having been a distribution of Q's contribution, but had made no election under paragraph (d)(2) of this section to have any amount distributed which was in excess of N's 1970 undistributed income treated as distributed out of corpus. Therefore, the first $225 of qualifying distributions made in 1971 (the sum of $100 and $125, N's distributable amount for 1970 and 1971, respectively) are treated as amounts described in paragraph (d)(1)(i) and (ii) of this section. Since Y's contribution is a contribution from a public charity and does not have to be "redistributed" and since R specifically instructed N that its contribution need not be "redistributed", the remaining $195 of qualifying distributions will be treated as distributed pro rata from Z's and Q's contributions, regardless of N's earmarking. Accordingly, of Z's original qualifying distribution of $70 only $65 ($195 multiplied by $70, Z's contribution, over $210, the total ($70 plus $140) of Z's and Q's contributions) will be treated as redistributed by N. Similarly, of Q's original qualifying distribution of $140 only $130 ($195 multiplied by $140 over $210) will be treated as redistributed by N. Thus, Z's gross income for 1972 will be increased by $5 ($70 less the $65 actually distributed), and Q's gross income for 1972 will be increased by $10 ($140 less the $130 actually redistributed).

C. Treatment of Qualifying Distributions

When a private foundation makes a qualifying distribution, it is necessary to determine the taxable year against which the distribution is to be credited. IRC 4942(h) and Reg. 53.4942(a)-3(d)(1) provide that qualifying distributions are treated as made:

(i) First, out of the undistributed income of the immediately preceding taxable year;

(ii) Second, out of the undistributed income for the taxable year to the extent thereof; and,

(iii) Then, out of corpus.

If a private foundation has no undistributed income for the immediately preceding taxable year, it may elect to treat any portion of a qualifying distribution as made out of the undistributed income of a designated prior taxable year, or out of corpus. The election to vary the normal sequence for treatment of qualifying distributions is made by filing a statement with the Commissioner during the taxable year in which the qualifying distribution is made, or by attaching a statement to the return the foundation is required to file with respect to the taxable year in which the qualifying distribution is made. The statement must contain a declaration by a foundation manager that the foundation is making an election, and it must specify whether the distribution is made out of the undistributed income of a designated prior taxable year(s) or out of corpus. An election made during the taxable year in which the qualifying distribution is made may be wholly or partially revoked by filing a revocation statement. Rev. Proc. 74-41, 1974-2 C.B. 495, provides that elections, other than those made by attaching a statement to a return, should be filed with the organization's key District Director.

The rules for the treatment of qualifying distributions are illustrated by the following two examples from Reg. 53.4942(a)-3(d)(3):

Example (1). M, a private foundation which was created in 1968 and which uses the calendar year as the taxable year, has distributable amounts and qualifying distributions for 1970 through 1976 as follows:

Year	**1970**	**1971**	**1972**	**1973**
Distributable amount	$ 100	$ 100	$ 100	$ 100
Qualifying distribution	$ 0	$ 100	$ 250	$ 100

Year	**1974**	**1975**	**1976**
Distributable amount	$ 100	$ 100	$ 100
Qualifying distribution	$ 100	$ 100	$ 100

In 1971 the qualifying distribution of $ 100 is treated under subparagraph (1)(i) of this paragraph as made out of the $ 100 of undistributed income for 1970. The qualifying distribution of $ 250 in 1972 is treated as made: (i) $ 100 out of the undistributed income for 1971 under subparagraph (1)(i) of this paragraph; (ii) $ 100 out of the undistributed income for 1972 under subparagraph (1)(ii) of this paragraph; and (iii) $ 50 out of corpus in 1972 under subparagraph (1)(iii) of this paragraph. The qualifying distribution of $ 100 in each of the years 1973 through 1976 is treated as made out of the undistributed income for each of those respective years under subparagraph (1)(ii) of this paragraph. See paragraph (e) of this section for rules relating to the carryover of qualifying distributions out of corpus.

Example (2). M, a private foundation which uses the calendar year as the taxable year, has undistributed income of $300 for 1981, $200 for 1982, and $400 for 1983. On January 14, 1983, M makes its first qualifying distribution in 1983 when it sets aside (within the meaning of paragraph (b) of this section) $700 for construction of a hospital. On February 24, 1983 a notice of deficiency with respect to the excise taxes imposed by section 4942(a) and (b) in regard to M's undistributed income for 1981 is mailed to M under section 6212(a). M notifies the Commissioner in writing on March 24, 1983, that it is making an election under subparagraph (2) of this paragraph to have its distribution of January 14th applied first against its undistributed income for 1982, next against its undistributed income for 1981, and last against its undistributed income for 1983. Thus, $200 of the $700 qualifying distribution is treated as made out of the undistributed income for 1982; $300, out of undistributed income for 1981; and $200 ($700 less the sum of $200 and $300), out of the undistributed income for 1983. Thus, an initial excise tax of $45 (15 percent of $300) is imposed under section 4942(a). Since M made the election described above, the $300 (treated as distributed out of undistributed income for 1981) corrects (within the meaning of section 4963(d)(2)) the taxable act because the undistributed income for 1981 is reduced to zero. Furthermore, correction is effected within the correction period (as defined in section 4963(e)(1) and Section 53.4963-1(e)). Therefore, under the provisions of section 4961(a), the additional tax imposed by section 4942(b) will not be assessed.

D. Carryover of Excess Qualifying Distributions

IRC 4942(i) and Reg. 53.4942(a)-3(e) provide that if a private foundation makes excess qualifying distributions in any taxable year in which it is subject to IRC 4942(a) tax, the excess distribution may be used to reduce distributable amounts in any taxable year of the "adjustment period," i.e., the five taxable years immediately following the taxable year in which the excess distribution occurred. The distributable amount is reduced to the extent of the lesser of:

(i) the excess of qualifying distributions made in prior taxable years to which the adjustment period applies, or

(ii) the remaining undistributed income at the close of the taxable year after applying any qualifying distributions made in such taxable year to the distributable amount for such taxable year.

During the five year adjustment period, if additional excess qualifying distributions occur, the latter excess is not taken into account until the earlier excess has been completely applied against distributable amounts during the adjustment period.

Reg. 53.4942(a)-3(e)(4) contains three examples that illustrate the provisions relating to the carryover of excess qualifying distributions. Also, Rev. Rul. 78-387, 1978-2 C.B. 270, describes a situation in which a private foundation has a carryover of excess qualifying distributions. There, the foundation transferred all of its net assets to another private foundation. Both foundations were controlled by the same persons. Citing Reg. 1.507-3(a)(9)(i), the revenue ruling holds that the transferee foundation is treated as the transferor foundation and, therefore, the transferee foundation may reduce its distributable amount by the excess qualifying distributions carryover of the transferor foundation

5. Application of Principles

Consider the following hypotheticals:

A. Toxic Waste Site

Organization M is recognized as exempt under IRC 501(a) as an organization described in IRC 501(c)(3) and is classified as a private foundation under IRC 509(a). It is not a private operating foundation under IRC 4942(j)(3). The organization's purposes are to organize, promote, foster, assist and conduct religious, charitable, scientific, literary and educational enterprises and activities in state O in accordance with the decisions of its Board of Trustees. Funding for M was derived from contributions made by its founder and his wholly-owned taxable corporations. Upon the death of the founder, M acquired all the stock of a number of taxable corporations. By 1973, most of the corporations were liquidated into M, which continued to operate the businesses as unrelated businesses until they were sold or discontinued. As part of the liquidation of the corporations, M acquired all the assets and liabilities of the corporations. As of the beginning of 1979, M was operating certain manufacturing plants and lumber yards, which were sold in 1980.

In 1982 M's Board of Trustees was informed that its commercial operations had resulted in the presence of waste material in the ground water of a certain area in State P. The state environmental department performed ground water sampling from water wells in the area, and the U.S. Environmental Protection Agency (EPA) conducted ground water, surface and soil, and sediment sampling. The EPA determined that the presence of hazardous substances at the site and their past and potential migration to surrounding soils, ground water and surface water constitute both an actual release and a threatened release of hazardous substances into the water supply. In order to protect the public health and welfare, and the environment, EPA determined that it was necessary to take action to mitigate the threat of any future release of hazardous substances into the environment.

M's trustees authorized M, together with Organization N, which also operated a facility at the site, to enter into a consent order with the EPA to provide for a study and work plan to determine the best method of removing hazardous substances and cleaning up the area. M admitted no liability. M intends to seek contributions from other parties, who owned or operated the facility. Funds contributed from these parties will be used to pay for a proportionate share of actual cleanup costs. M and N have agreed to an equal division of the costs of the cleanup operation. M requests a ruling that expenditures made directly in connection with the cleanup of any pollution or hazardous substances at the site are qualifying distributions under IRC 4942, that these expenditures are consistent with M's charitable purposes, and that they are paid to accomplish one or more of the purposes described in IRC 170(c)(1) or 170(c)(2)(B).

Although M has not formally admitted liability, the relevant environmental statutes indicate that M is strictly liable for any damage caused as a result of the release of hazardous substances at its previously owned site. Having owned and operated the manufacturing plant and lumber yard, M directly benefited from these activities, and is legally liable for the cleanup operation. M's decision to pay for the cleanup of the waste site was not based on the furtherance of charitable purposes; rather it was based on the liability imposed by environmental law, with the expectation that this liability would be extinguished upon completion of the cleanup operation.

Restoring or protecting the environment can be consistent with charitable purposes under IRC 501(c)(3) and 170(c)(2)(B). Nevertheless, for purposes of the deductibility of charitable contributions, there must be a voluntary transfer of money or property made by the transferor without receipt or expectation of financial or economic benefit. Further evidence that M is not making a transfer described in IRC 170(c)(2)(B) is found in M's plan to seek contributions from other potentially responsible parties, who owned or operated the facility. This plan, along with the arrangement with N, substantiates the fact that M is treating its cleanup costs in the same manner as would any commercial entity seeking recovery from third parties. On this basis, the Service position is that amounts paid by M in connection with the toxic waste cleanup do not constitute qualifying distributions under IRC 4942(g)(1)(A). Nor do the amounts satisfy the requirements of IRC 4942(g)(1)(B), since the manufacturing plant and lumber yard were not used (or held for use) directly in carrying out one or more purposes described in IRC 170(c)(2)(B).

B. Forgiveness of Rent

Organization X is recognized as exempt under IRC 501(a) as an organization described in IRC 501(c)(3) and is classified as a private foundation under IRC 509(a). It is not a private operating foundation under IRC 4942(j)(3). X purchased improved waterfront property from Organization Y. X's representative stated that the property had been purchased for investment purposes. X entered into a written year-to-year lease with Organization Z for the use of the property. The lease provided for an annual rent in excess of $50,000. Z is recognized as exempt under IRC 501(a) as an organization described in IRC 501(c)(3), and is described as a church under IRC 509(a)(1) and 170(b)(1)(A)(i). Z used the property in connection with its religious activities. X decided not to collect the rental amount due pursuant to the written lease with Z. On its Form 990-PF, X reported the rent provided for in the lease as "gross rents"; it also reported the forgiveness of the rent as "contributions, gifts, grants." X argues that the forgiveness of the rent should be treated as a qualifying distribution under IRC 4942(g)(1).

The Code and regulations define a qualifying distribution as an amount paid to accomplish one or more purposes described in IRC 170(c)(1) or 170(c)(2)(B). The legislative history also refers to "expenditures" and "payouts" in describing ways to prevent avoidance of the current benefits to charity objective. Thus, the definition of a qualifying distribution contemplates an actual payout during a taxable year, or a set-aside. The Service position is that the minimum payout provisions require an actual cash distribution or a dedication of assets for charitable use. Supporting this position is Rev. Rul. 74-560, 1974-2 C.B. 389, which holds that a private foundation should not be given credit for a qualifying distribution in the amount of the depreciation for an asset. Like depreciation, forgiveness of rent entails no current payout or dedication of property for a charitable purpose.

6. Conclusion

With the enactment of IRC 4942 as part of the Tax Reform Act of 1969, Congress signaled its intention to force private foundations to make minimum distributions to charity on a current, annual basis. The method selected by Congress is quite thorough, and is designed to eliminate subjective determinations relating to whether a foundation's accumulation of income is reasonable. At the heart of this statutory scheme in IRC 4942 is the concept of qualifying distributions. This term itself encompasses a variety of tests and rules affecting such provisions as set-asides, grant administrative expenses, and the "twelve-month pass-through rule". The best source of enlightenment in dealing with qualifying distributions is the regulations under Reg. 53.4942(a)-3; especially pertinent are the descriptive examples contained therein. When faced with a difficult issue involving qualifying distributions, it might be useful to review the examples in the regulations to determine whether they have any applicability. Consideration should be given to requesting technical advice on issues for which there is no published precedent, under the procedures set forth in IRM 7(13)12.